Comptroller of the Currency
Administrator of National Banks

Agricultural Lending

Comptroller's Handbook

December 1998

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Assets

This booklet addresses the fundamentals of agricultural loan underwriting and administration, and provides guidance for examining those activities in national banks. It is one of a series of specialized lending booklets contained in the Comptroller's Handbook, and supplements the overall guidance contained in the "Loan Portfolio Management" booklet, as well as the "Large Bank Supervision" and "Community Bank Supervision" booklets.

Background

Bank credit has played an important role in farm activities throughout U.S. history. The financing supplied by banks over the years has been essential to many individual farm operators and to the development of new agricultural technologies and techniques. As with all forms of lending, however, agricultural credit presents the banker with a unique set of risks.

Each region of the country has unique conditions that are reflected in the variety of commodities produced and marketed. Typically, there is at least some product diversification within a region; however, because of the interrelationships between many farm products and activities, and their influence on surrounding communities, agricultural concentrations are an everyday risk for many community banks. Moreover, each agricultural enterprise has its own technology, restrictions, and challenges for both the borrower and the bank lender.

The traditional role of bank credit in agriculture has been to fund seasonal production and longer term investments in land, buildings, equipment, and breeding stock. As with most business loans, the repayment of agricultural loans depends primarily on the successful production and marketing of a product, and only secondarily on the collateral taken for the loan. In some cases, non-farm, salary income may also be available, but it is often devoted to family living expenses and usually plays only a supporting role in the loan decision.

Consolidation has had a dramatic effect in recent years, both on the number of farms and the number of banks in predominantly agrarian geographies. The challenges facing farmers and farm lenders, however, have not subsided. Increased market risk from the elimination of government price supports is requiring farmers to take additional steps to continue as successful operators. They must become more familiar with global markets and the influences underlying demand for their products, and this, in some cases, is requiring more diversification. Environmental considerations and urban sprawl are also becoming increasingly important factors in agricultural decision making. These structural changes and increased risks reinforce the need for close cooperation between farmers and their lenders.

Agricultural Lending Market

Commercial banks continue to be highly competitive in the agricultural credit market; however, there are a number of other influential participants, some of which have increased their involvement in recent years. These include:

- **Farm Credit System (FCS)**. The FCS is comprised of cooperative institutions regulated by a federal, arms-length regulator, the Farm Credit Administration. FCS retail lending (to individual farmers) is centered in local farm credit associations. Wholesale lending (to FCS institutions) is shared between the Farm Credit System Funding Corporation and the regional farm credit banks. The FCS relies exclusively on bonds to fund its lending operations. The liability for FCS bond underwriting is jointly and severally shared by the farm credit banks and is guaranteed by the Farm Credit System Insurance Corporation. The bonds are high quality and similar to U.S. Treasury securities, but, as with many agency-issued securities, they are not backed by the full faith and credit of the U.S. government. They are purchased primarily by financial institutions. FCS lenders traditionally have been most competitive in the agricultural real estate market, because they can issue long-term bonds to offset their interest rate exposure on long-term mortgages.

- **Farm Service Agency (FSA)**. The FSA, formerly known as the Farmers Home Administration, is the agency within the U.S. Department of Agriculture that administers federal agricultural lending programs. (A description of the federal loan and guaranty programs can be found in Appendix A.) FSA loans are funded from the Department of Agriculture's budget and from funds repaid by borrowers. The Farmers Home Administration traditionally had been the lender of last resort in agriculture and had focused on loans for rural development and rural housing. Recently, however, budget austerity has caused the FSA to focus its resources more narrowly on serving small, less experienced, and disadvantaged farmers.

  – **Life Insurance Companies**. These companies lend primarily to corporate agricultural enterprises — generally, borrowers financing amounts greater than $1 million.

  – Other lenders include parents financing their children into agriculture, landlords providing self-financing for their tenant farmers, and captive lenders. Captive lenders, such as equipment dealers, seed companies, and retailers normally provide limited-purpose credit to enhance market penetration for their primary products, such as farm machinery and seed.

Risks Associated with Agricultural Lending

The OCC's examiners assess banking risk relative to its impact on capital and earnings. From a supervisory perspective, risk is the potential that events, expected or unanticipated, may have an adverse impact on the bank's capital or earnings. The OCC has defined nine categories of risk for bank supervision purposes. These risks are: credit, interest rate, liquidity, price, foreign currency translation, transaction, compliance, strategic, and reputation. These categories are not mutually exclusive; any product or service may expose the bank to multiple risks. For analysis and discussion purposes, however, the OCC identifies and assesses the risks separately.

In the current context of agricultural lending, the most significant risks are credit, liquidity, transaction, and reputation.

Credit Risk

Credit risk is the most significant risk associated with agricultural lending. A farmer's production and ability to service debt can be affected seriously by weather conditions and other natural factors not directly under the farmer's control. Moreover, agricultural markets are sensitive to highly variable supply and demand conditions in world markets that may directly or indirectly affect both the borrower's repayment capacity and the value of the bank's collateral.

Aside from weather conditions, the most significant variables affecting agricultural credit risk are market prices and government policies. Other important factors include concentrations and limited-purpose collateral.

Market prices Market prices pose the risk of loss to farmers from unforeseen input or output price changes. Examples include unexpected expenses for feed, fuel, and fertilizer (input), or depressed prices due to record crops (output). Farmers may mitigate the risk of losses from price fluctuations by numerous methods, including diversifying their crop and livestock activities, hedging commodities under production, and contracting (pre-selling) production.

Government agricultural policies. Historically, federal price support programs have reduced price volatility for program crops. However, the Federal Agriculture Improvement and Reform Act of 1996 (Farm Bill) included significant changes to crop subsidy programs. Among other things, the Farm Bill phases out crop subsidies over a seven-year period. Eligible farmers will get fixed, sliding-scale payments through 2002. Fundamentally, the Farm Bill will eliminate price protection for several crops and shift to farmers greater risk for market price volatility.

Concentrations. Agricultural loan concentrations occur naturally when banks are located in communities with agriculture-dependent economies. For many individual agricultural banks, concentration risk is high. In addition to concentrations in crop and livestock loans, other farm-related assets can form concentrations. For instance, banks may also lend to companies that deal exclusively with agricultural enterprises, such as seed companies, grain elevators, and farm machinery dealers. Additionally, they may invest in securities from agencies participating in the government's agricultural lending programs.

Limited-purpose collateral. Agriculture-related collateral affects credit risk because it may have few or no alternative uses to support values when loan repayment problems arise. For example, a broiler house may have very little residual value when a borrower loses a contract with a poultry concern. Additionally, commodity prices and land values are sometimes highly correlated, especially in agricultural regions where farm land has no alternative productive use when commodity prices fall to a level that is inadequate to repay debt. In regions that contain substantial multi-use properties, however, there may be minimal correlation between land values and commodity prices.

Appraisers commonly evaluate farm collateral based on market value, not liquidation value, and this too, can affect collateral values. This practice is normal; however, in distressed situations, liquidation values can deviate dramatically from market values, causing significant differences between collateral value and outstanding loan balances.

Because of correlations among agricultural risk factors, stress testing can be an important part of a bank's risk management process. (Refer to the "Loan Portfolio Management" booklet for more information about stress testing.)

Liquidity Risk

The nature of agricultural lending can result in higher liquidity risk at some banks, especially smaller banks located in areas where the economy is dominated by one or a few crops, or other farm products. High credit concentrations are usual under those circumstances, and a bank's liquidity can become strained if crop losses or unfavorable market conditions result in deferral of loan repayments. Longer term liquidity pressure may result at some banks as a result of discontinued farm operations and population migration to urban areas.

Transaction Risk

Transaction risk primarily results from the numerous documentation, inspection, control, and monitoring requirements associated with agricultural lending. An inadequate understanding of these requirements, or failure to comply with them, may lead to serious credit weaknesses, including ultimate collection problems. When this occurs, it is most often the result of either lender complacence, inappropriate assumptions about a borrower or collateral, or both.

Reputation Risk

Banks with lending activities to borrowers in certain agricultural enterprises can face increased reputation risk. For example, a bank may finance operations that generate large amounts of animal waste that may contaminate water sources and cause other ecosystem damage. Public perception and potential litigation may cast the bank, along with the borrower, as an adversary to be held responsible for clean-up.

A bank's reputation can also be damaged if it reduces the availability of farm credit or forecloses on farm collateral. If the foreclosed farm property has been in a family for generations, the bank's action — although probably prudent from a safety and soundness perspective — may be negatively viewed by the community.

Agricultural Loan Underwriting

Although agricultural lending involves some unique requirements, it requires many of the same fundamental underwriting practices as other forms of lending. The process begins with current, accurate, and complete credit data. Current credit information generally is considered to be no more than 12 months old, but this practice may vary depending on the farmer's financial condition and type of operation. Specific requirements should be detailed in the lending bank's policy. Whatever form the information takes, it should provide the account officer with sufficient insight into the farmer's operations to develop accurate financial statements, cash flow projections, and budgets. Credit files should be documented with this information during underwriting, as well as information obtained and used during ongoing loan administration.

The underwriting process, and subsequent loan administration, should be governed by an effective set of lending guidelines. The guidelines may be formal or informal, but should be rigorously applied in either case.

At a minimum, the underwriting guidelines should require:

- In-depth financial analysis.
- Structuring loans in accordance with the type of borrowing and the expected income stream.
- Reliable collateral evaluations and margins, and/or other steps to minimize credit risk.
- Effective ongoing monitoring practices, including segregation of any prior period crop carryover debt.
- Thorough evaluation of the borrower's character and history of managing debt repayment.

Subsequent sections of this booklet expand upon these minimum guidelines.

Some larger banks use credit scoring as a basis for making agricultural credit decisions. In those cases, the scoring model should be consistent with the guidance contained in OCC Bulletin 97-24, dated May 20, 1997.

Financial Analysis

The quality of financial information for agricultural operations varies significantly. In general, traditional small-farm operations use cash-basis tax returns and market-value financial statements that are self-prepared and unaudited. Larger operations and vertically integrated companies frequently will submit audited, accrual-basis financial statements.

When reviewing a farm operation's cash flow, it is important to understand that farmers have the option of reporting income for tax purposes on either a cash or an accrual basis. As a result, reported cash flow levels may require further analysis. By using cash accounting, the timing of crop sales and purchase of supplies can be used to minimize taxes. For instance, fertilizer can be bought at year-end, expensed to the preceding crop, and used in the next tax year. The purpose of this treatment is to minimize the effects of losses in bad years by allowing expenses to be allocated to good years.

Because of the broad spectrum of agricultural activities (livestock, fruit, grain, dairy, storage elevators, vineyards, nurseries, and others), the types of financial analyses involved in farm lending also vary. Each operation presents issues that are unique, and it is important that the bank lender fully understand the critical factors and nuances associated with each operation being financed. Despite their differences, however, some key elements of financial analysis apply to all situations. These are:

- Reviewing the reasonableness of budget assumptions and projections.

- Comparing projections with actual results
- Assessing working capital adequacy.
- Analyzing net worth changes.
- Assessing the impact of capital expenses.
- Evaluating any supplementary sources of income.

Financial projections, whether prepared solely by the borrower or jointly with the banker, should be realistic when compared with historical or regional standards. All assumptions should be clearly documented and subjected to sensitivity analysis.

Some agricultural borrowers, particularly smaller operators, submit only one financial statement annually. In these instances, the best way of determining an operator's effectiveness is by comparing projections with actual historical performance. This involves reviewing and comparing results for several fiscal periods. It would not be unusual for a loss year(s) to be experienced during this period; however, the analysis should focus on determining whether profitable years more than offset loss years.

Trend analyses can also provide a reliable basis for credit decisions. As an example, increases in reported property values and net worth resulting primarily from simply increasing the carrying value of already-owned property should be closely analyzed to confirm that the new values are consistent with local market conditions. By performing this type of analysis, and making any necessary adjustments, the lender can help ensure that loan amounts do not exceed the borrower's realistic collateral values and ability to repay.

Some operations require large, ongoing capital expenditures to replace equipment or machinery, maintain industry standards, and remain competitive within their market. The lender should determine the financial impact of such "maintenance" capital expenditures as well as the appropriateness of capital expenses for expansion or modernization. In some cases, the farmer may be motivated to improve the operation's cash flow by delaying or forgoing maintenance or investment capital expenditures. The bank and the farmer must understand the risk involved in these practices and evaluate their potential impact on ongoing operations and loan performance.

Many agricultural borrowers have sources of income other than from their crops or livestock, such as cash rents, royalty payments, custom work, government payments, and non-farm salary. It is important to evaluate the level, duration, frequency, and availability of this income. Any loan repayments dependent on these sources should coincide with their receipt.

Loan Structure

Structure is especially important in agricultural loans and should be based on the purpose for which the loan was made. When structure and purpose are not properly matched and enforced, the effectiveness of bank management's loan supervision, including the ability to spot performance problems, can be compromised. Poorly structured loans also increase the possibility that proceeds will be used for unintended purposes. These problems might result, for example, when short-term loans for crop production are diverted by the borrower into the purchase of machinery.

Short-term Loans. Most loans for the production of crops and for livestock feeder operations are intended to be self-liquidating at the end of the growing cycle from the proceeds of product sales. Therefore, the maturities of these loans should coincide with the production cycle for the product being financed, usually one year or less. (Note: some agricultural industries such as forestry, orchards, and aquaculture may have production cycles greater than one year and require longer term financing.) As a general rule, all anticipated costs required to take a crop from planting to harvesting (fuel, labor, fertilizer, seeds, etc.) are included in a farmer's short-term operating line. Unanticipated costs may, however, require additional short-term credit to assure that the product makes it to harvest. One well-known example of this is when heavy spring rains cause seeds to rot in the ground, necessitating a second planting. In such circumstances, the borrower comes under increased pressure to generate sufficient proceeds from the current crop to repay both the original and add-on loans and avoid a "carry over," work-out situation. In other cases, however, short-term production credit may purposely be carried beyond the current growing cycle to enable the borrower to store or defer sale of products in anticipation of higher market prices.

Long-term Loans. More commonly referred to as "term" loans, this type of farm credit is normally associated with the purchase or development of capital assets, such as real estate, machinery and equipment, breeding herds, and orchards. Final maturities vary, depending on the useful life of the asset financed or collateral pledged, but generally do not exceed 30 years. The primary source of repayment normally is cash flow from operations, with liquidation of collateral viewed only as a contingent, secondary source.

Carry-over Debt. This refers to restructured short-term debt, such as the unpaid portion of an annual operating line, resulting from the borrower's inability to liquidate the debt as originally planned. It essentially represents a substitute for investment capital. (Further discussion of carry-over debt appears later in this booklet.)

Advance Rates

Advance rates should consider the cost or other estimate of current value of the collateral pledged, along with its useful life, depreciation rates, and vulnerability to obsolescence. Because of the highly specialized nature and occasionally large fluctuations in the value of much farm collateral, advance rates should include a reasonable margin of protection against unanticipated adverse events. When such margins are not available in the primary collateral, banks frequently obtain additional, secondary collateral.

In cases in which a bank offers terms that are more liberal than its policy or practices normally would permit, the bank should have a process to identify, approve, document, and monitor the exceptions. Moreover, to gain the maximum benefit from such a process, it should provide data, not only on individual exceptions, but also on the aggregate level. Such aggregated data can provide a more complete picture of risk in the portfolio and reveal weaknesses in the underwriting process, or in the policy itself, that may need to be addressed. Because agriculture portfolios often constitute concentrations, exception monitoring takes on heightened importance as a means to control credit risk.

Collateral Valuation and Documentation

Bank guidelines for collateral should include procedures for determining collateral values and perfecting the bank's lien.

Collateral Evaluation. The current values of all collateral should be established during the underwriting process. Thereafter, stored crops and livestock should be re-evaluated on a periodic basis, with the frequency increasing during periods of price volatility. Real estate, machinery, and equipment should be re-evaluated whenever market conditions or other information leads the lender to believe the collateral's original assigned value may have become impaired. Independently derived values usually provide the most objectivity, but regardless of who provides them, the individual should be thoroughly knowledgeable about the type of collateral being reviewed. Among the critical information that should be documented in all collateral valuations are the:

- Location and identifying details about the collateral.
- Fair market value estimate as of a specific date.

- Source of, or basis for calculating, the value estimate.

In assessing the value of cash ***crops*** on hand, normal practice is to include all harvested crops being held for sale and stored in the farmer's storage facilities, in an elevator, or elsewhere. These crops should be valued using the current market price, unless there is documented evidence that the borrower has a firm, contracted price for the crops, in which case the contracted price normally must be used. While valuing crops at the current market price will generally provide an appropriate current value, current market price may not always be an accurate measure for determining the collateral position due to the volatility of some commodity prices. It may be appropriate to employ some level of historical averaging while also considering current market conditions and future projections. Crops for feeding the borrower's own livestock, and seed intended to be used for the borrower's own planting, should be treated for underwriting purposes as operating expenses, not as liquid collateral. The location, amount, and condition of all harvested or "finished" crops should be verified by the lending bank. In addition, when crops are stored away from the borrower's own premises, the bank should be especially careful to confirm the borrower's rights of ownership and possession.

Livestock may be located on the farmers own premises, at a third-party feed lot, or elsewhere, and, as with crops, the lender should confirm the borrower's rights of ownership and possession. Values can be obtained from numerous providers; however, trade publications and purchase bills from sale barns are the most often used sources. Because livestock values may fluctuate dramatically depending on factors such as the animal's age, health, breed, sex, and reproductive capacity, the individuals performing livestock inspections should be capable of recognizing these issues, making appropriate adjustments, and documenting the results.

Some farm ***machinery and equipment*** are adaptable to a wide variety of uses, which improves their marketability by increasing the universe of potential buyers in the event the collateral is liquidated. Conversely, other machinery and equipment may be highly specialized or not commonly used in a particular area, and thus not as readily saleable. One generally used valuation source for major used equipment is the Official Farm Equipment Guide Book. Also, local auctioneers and equipment dealers frequently are reliable sources of information.

The appraisal or evaluation techniques used for agricultural ***real estate*** are essentially the same as those used for other types of real estate. Real estate collateral must conform to the regulatory agencies' appraisal regulations, which, for national banks, can be found in 12 CFR 34.43(a). In those cases where the regulation does not require an appraisal performed by a state certified or licensed appraiser, the collateral must be supported instead by an evaluation that complies with the agency's appraisal guidelines. Such an evaluation may be performed by a qualified bank employee; however, that person should not supervise the credit to which the collateral is pledged. If a bank's limitations prevent this separation of functions, the completed evaluation should be reviewed by someone other than the person performing the evaluation. When reviewing real estate collateral, it should be noted that in order to qualify for the "abundance of caution" exemption provided in 12 CFR 34.43(a)(2), the bank must clearly document how the loan is wellsupported by income or other collateral of the borrower and that the real estate is taken merely as additional collateral.

Subsequent events or economic changes may cause real estate values to fluctuate. When this occurs, collateral valuations may need to be updated. Depending on the relative financial strength of the borrower and the bank's reliance on the underlying collateral, an approximate market value based on the banker's knowledge of local market conditions may be adequate. In other instances, a new appraisal will be necessary.

During periods of escalating values for farm land, both the economic value and market value of the land should be considered. The economic value of the land is based on the revenue the land will produce when operated as a farm, given expected crop yields and current crop prices. It provides an indication of the amount of debt the land will support. Differences between the economic value and the market value of the land should be reconciled.

One valuable source for obtaining current real estate values is the state agricultural extension office. Those offices typically have agricultural statistics that will provide the average value of real estate by county. Usually, they can also provide information about the average cash rent paid for real estate. Other sources that provide statistical data and industry ratios include: The Dairy Herd Improvement Association, Doan's Agricultural Report, the Federal Reserve Bank, local and state colleges and universities, the local agricultural production association, and Robert Morris and Associates (RMA).

Lien Perfection. Complete and accurate lien perfection is crucial to protecting the bank's interest. Agricultural collateral most often consists of chattel (personal property, such as livestock, crops, or equipment) and real estate. The methods for obtaining and perfecting security interests in each type of collateral are dictated by the Uniform Commercial Code (UCC) and the real estate laws of each state.

- **Chattel Liens**. The model UCC, which provides the process for securing chattel collateral, has been adopted with minor variations in all states except Louisiana. (Louisiana's guidelines for securing chattel are primarily outlined in the state's Napoleonic guide, although certain portions of the UCC have been adopted.) Examiners should become familiar with the relevant state's securitization and perfection requirements for the collateral being reviewed. In general, such requirements will include obtaining a signed Security Agreement and filing appropriate documentation with either the county or state, depending on the type of collateral being perfected. With some types of collateral, multiple filings may be necessary to ensure lien perfection.

Lien searches should be completed each time a loan is made to assure the lender of its position relative to other lenders and to identify other creditors. Lenders must also ensure that UCC filings remain current, as they expire periodically and have specific renewal requirement.

Searches can be performed by attorneys, title companies, or bank personnel, and all findings should be documented in the loan file. Negative findings need appropriate action and resolution.

Section 1324 of The Food Security Act of 1985 (7 USC 1631) contains additional notification and filing provisions that are designed to protect purchasers of farm products from liens about which they may not be aware. Under this section, a bank may safeguard its interest by providing a pre-sale notification of its security interest in the farm products directly to the farm product purchasers. This section also permits a bank to protect its interest by registering its security interest with the secretary of the state in which the farm products were produced, if that state has established a qualified central filing system.

- **Real Estate Mortgages/Deeds of Trust**. When considering real estate as collateral, a bank should first determine whether there are any existing liens against the property. As with chattel liens, real estate lien searches may be performed by attorneys, title companies, or bank personnel, and all findings should be documented. Because real estate loans normally are comparatively large and/or the borrower's interest in the property may be clouded, a bank may require title insurance, with itself as loss payee, to protect against possible undisclosed title defects. Whether insured or not, the bank should review carefully any "exceptions" noted in the preliminary lien search or title insurance binder. If the exceptions are serious, they should be cleared up before the loan closing. Unpaid taxes deserve particular attention, as they normally constitute a prior or superior lien to all others.

  In some small agricultural communities with relatively stable real estate ownership, banks rely on an ownership and encumbrance (O&E) report to determine outstanding liens. Typically, these reports are prepared by in-house or local attorneys, based on periodic reviews of county records of real estate transactions. This is a less costly, but also less conclusive process than a complete search performed contemporaneously with making the loan.

If the real estate includes a homestead or other buildings which comprise a significant portion of the total value upon which the bank is relying for collateral protection, then hazard insurance (fire, flood, wind, and/or hail) should be obtained, with the bank named as loss payee.

As with chattel collateral, the bank must ensure that its real estate collateral documents are accurately completed, recorded as necessary, and maintained. A well-documented real estate loan typically includes most or all of the following:

- Preliminary title opinion (prior to filing the lien for recording.
- Final title opinion (subsequent to lien recordation).
- Title insurance, if required.
- Promissory note.
- Recorded mortgage or deed of trust.
- Pledges, assignments, hypothecations, if required.
- Hazard insurance for significant structures.
- Fair market value appraisal and/or evaluation.
- Environmental report, if required.

Other Credit Risk Management Options

Because farm commodities are subject to fluctuating market prices, extreme weather, and other perils that can jeopardize repayment, farm borrowers and bankers often use other methods to mitigate risk.

Government Programs. Various government programs may limit farm risk. As an example, by entering the Conservation Reserve Program, farmers contractually commit to limit crop production on certain portions of their land. The farmer receives annual payments established by bid at the inception of the contract.

Crop Insurance. As a risk management option, lenders may require or encourage use of crop insurance. Many farmers consider insurance as beneficial and as necessary as feed, seed, or fertilizer. Insurance is available to cover moderate and catastrophic losses of production caused by weatherrelated difficulties, such as hail and floods. In the event of crop loss, insurance will pay a percentage of crop value.

Forward Contracting. Producers often use contracts with packers or grain buyers to market their production. These contracts vary widely and have to be analyzed carefully as they sometimes can actually increase risks rather than mitigate them.

Hedging. Hedging can be a complex practice and is practiced generally by larger operations. The practice is used to mitigate the effect of market volatility through the buying or selling of futures contracts—legally binding commitments to sell or buy a commodity in the future at a previously determined price. Futures contracts for each type of commodity have standardized, non-negotiable features, such as quantity, quality, time of delivery, and place of delivery. Only the price component of a futures contract is negotiable. Most futures contracts do not result in delivery of the physical commodity. Instead, the contract's delivery requirement is offset when the owner of a contract takes an equal and opposite position. For example, a projection of record harvests may give a farmer the incentive to sell a futures contract to lock in the price at which he can sell a particular commodity at a future date. Alternatively, a farmer wishing to protect against rapid price increases in the cost of feed may purchase a contract to take future delivery at a pre-determined cost.

Borrowing Base Certificates and Loan Covenants. Many farm lenders require protective covenants and other affirmative undertakings by the borrower as part of the loan underwriting process. Frequently, this includes establishing financial ratios and collateral margins that the borrower must maintain during the term of the loan. Such arrangements typically require the borrower to periodically provide the bank with a completed certificate attesting to compliance with collateral margins and other conditions. These controls aid the banker in detecting trends and early signs of credit deterioration. On some short-term operating lines, banks will in fact require the borrower to submit requests detailing the purpose of each advance against the approved line. This helps the bank ensure that funds are advanced only for approved purposes.

Ongoing Monitoring

Ongoing monitoring is a critically important component of the vigilance necessary to ensure safe and sound agricultural lending. This requires not only remaining abreast of the borrower's operations, but also independently keeping up with market events that may affect the borrower. Naturally, a bank should intensify its inspections and other monitoring when there is reason to believe that a borrower's financial condition or the pledged collateral may be deteriorating.

Inspections and Re-evaluations

Ideally, inspections and re-evaluations will be performed by a qualified person other than the lending officer who was responsible for the credit decision. However, when such a separation of duties is impossible or impractical, every effort should be made to periodically re-affirm inspection results by independent means. Methods that banks have used to accomplish this include periodically rotating the inspection duties among bank personnel other than the primary lending officer, using outside directors as inspectors/re-appraisers, and contracting the services of an independent third party. Moreover, as with any confirmation process, greater credibility is placed on the results of inspections conducted on an unannounced basis.

Short-term production loans require varying degrees of collateral monitoring in addition to financial analysis and initial collateral perfection. This typically includes periodic inspections and re-appraisals/evaluations. Depending on the type of collateral and the operating cycle, the lender should inspect and re-evaluate short-term collateral at least once during the term of the loan. In general, most agricultural lenders are aware of the growing conditions in their trade area, which gives them a sense of what to expect of borrower crop conditions.

Breeding stock normally should be inspected at least annually. Some livestock, such as those being fed to market weight or the offspring from reproduction, are under the borrower's control for less than one year. In these cases, the lender should inspect and appraise the collateral at least once during the period of ownership. Many banks maintain an in-house running inventory of livestock bought and sold which they compare with the results of the inspection.

For stored commodities, third-party warehouse receipts in the possession of the bank normally provide suitable evidence of the collateral. On-site inspections, however, should be performed when products are stored in the borrower's own facilities or in other non-bonded facilities.

Non-real estate collateral supporting term debt should be inspected and valued on a periodic basis. Collateral condition and marketability should be included in the documentation.

Agricultural Loan Classification

There are no mandatory rules to direct examiners how to treat agricultural credit. Instead, each lending relationship should be analyzed to determine how its individual characteristics compare with the following key criteria:

- Is the loan performing according to its original or reasonably modified terms?

- Is collateral sufficiently liquid, marginated, and controlled to fully protect the loan in the event of the borrower's default? (Consider the cost of liquidating collateral.)
- What is the borrower's financial condition, i.e., liquidity, leverage, cash flow, free assets?
- What has been the borrower's historical farming and borrowing performance?
- Are there other strengths (e.g., crop insurance, significant guarantors, and family support) not mentioned previously?

Although none of these individual criteria are determinative of the appropriate supervisory treatment of any farm loan, positive answers to most or all of them would indicate a likelihood that the loan should be "passed" by examiners. Conversely, negative answers to most or all would indicate an increased likelihood that the loan deserves some degree of criticism.

Production Loans

Perhaps the most volatile form of agricultural lending is short-term production credit. Normally, production loans are self liquidating, with repayment occurring shortly after harvest from sale of the crop for which the loan was made. When a bank has a reasonable process to analyze projected cash flow and the projected cash flow indicates the borrower has the ability to repay the operating loan, the current year operating notes are normally rated pass.

When operations have deteriorated and it becomes apparent that the current operating cycle will not result in sufficient production to cover the bank's operating loans, the decision to classify the loan and the severity of classification should begin with a review of the primary collateral, the financial strength of the borrower, and any other sources of repayment.

The amount of collateral represented by cash crops being held for future sale is considered liquid collateral if the value is properly documented with a current market price, the lien is perfected, and the location is verified. Any loans, or portions of loans, covered by this collateral are normally rated pass.

The proper classification for any portion not covered by the liquid collateral will depend upon the borrower's repayment capacity and the value of any other collateral.

Livestock Loans

Loans to feeder livestock operations also are expected to be self-liquidating. If a feeder operation deteriorates and the loans warrant classification, the portion of the loan covered by the liquidation value of the feeders should be passed if there is a current, on-site, livestock inspection report detailing number of livestock, weight, and current market value. Due to the volatility of livestock values and the relative ease with which the livestock can be moved, the frequency of inspections should increase commensurate with the severity of the borrower's financial problems.

The classification of loans to finance breeder livestock or dairy cattle is performed in a similar fashion to that of feeder loans. Although the primary source of repayment for such loans is the successful reproduction of the livestock or milk sales, the underlying liquidation value of the breeding or dairy livestock provides the same type of readily marketable, liquid collateral support as that of feeder livestock.

As with crop loans, secondary sources of repayment and the existence of other collateral may limit the severity of any classified portion.

Equipment Loans

Loans to finance machinery and equipment are considered capital debt. They should be supported and serviced from profitable operations, including any rental income derived from the equipment. These loans should be structured to ensure repayment within the useful life of the equipment. If the debt is being payed as agreed, according to a reasonable repayment program, and the source of repayment is generated through profitable operations, the debt would usually be rated "pass."

Additional investigation is warranted when equipment loans are being paid with advances on short-term operating loans, because operations are not sufficiently profitable. A thorough analysis of repayment capacity should be conducted, and the debt should be considered for classification.

When classifying collateral-dependent equipment loans, it is important to have current, documented values for all pieces of equipment, including date and source of valuation. Independent appraisals are preferable, but values provided by management are acceptable if sufficiently documented. If the collateral values support outstanding balances, a substandard classification is normally appropriate.

If the debt is not fully protected by the value of the collateral, a loss classification should be considered for the residual balance unless the debtor has the ability to provide additional security or an alternate source of repayment.

Carryover Debt

Carryover debt refers to restructured, short-term loans resulting from the farmer's inability in a prior cycle to generate sufficient cash flow to liquidate that cycle's production loans. It represents a substitute for investment capital and must be serviced through future cash flow, sale of unencumbered assets, or other sources. By its nature, carryover debt suggests a well-defined credit weakness. However, the examiner must not automatically classify carryover debt and should carefully examine all relevant data to ensure an accurate rating. In addition to the criteria outlined at the beginning of this section, the examiner should consider the following factors:

- The size of the carryover debt in relation to the size of the debtor's operation.
- Whether the obligor can service the carryover debt, as well as all other debt, within a realistic time frame.

When carryover debt is not covered by collateral and repayment capacity is not evidenced, a loss classification may be appropriate.

Please refer to the "Classifications of Credit" section of The Comptroller's Handbook for National Bank Examiners for general information about credit classifications.

Allowance for Loan and Lease Losses

For purposes of maintaining an adequate Allowance for Loan and Lease Losses (ALLL), the OCC encourages banks to segment their portfolios into as many components as practical. Agricultural loans that share similar characteristics should be segmented into pools and analyzed separately. For example, the market conditions and factors that affect crop loans will differ somewhat from those that affect livestock. Both of these portfolios lend themselves to treatment as separate pools in the ALLL analysis. In addition, the ALLL analysis should consider the level and risk associated with any carryover debt. Further guidance is contained in the "Allowance for Loan and Lease Losses" booklet of the Comptroller's Handbook.

General Procedures

These procedures should be used in conjunction with the "Loan Portfolio Management" booklet and the Classification of Credit section of The Comptroller's Handbook for National Bank Examiners. It is important for the examiner conducting the agricultural lending examination to work closely with the LPM examiner to identify mutual areas of concern and maximize examination efficiencies. Most of the information required to perform these procedures will be available from the LPM examiner.

After completing the general procedures, select from among the following examination procedures the necessary steps to meet examination objectives. Seldom will it be necessary to perform all of the steps during an examination.

Objective: Determine the scope of the examination for agricultural lending.

1. Review the following to identify any previous problems. Determine the status of planned corrective action.

    - Previous ROE.
    - Bank management's response to previous examination findings.
    - Previous examination working papers.
    - Bank correspondence concerning agricultural lending.
    - Audit reports, and working papers if necessary.
    - Supervisory strategy and overall summary comments.
    - EIC's scope memorandum.

2. Obtain from the EIC the results of analyses of the UBPR, BERT, and other OCC reports. Identify any concerns, trends, or changes involving agricultural lending since the last examination. Examiners should be alert to growth rates, changes in portfolio composition, loan yields, and other factors which may affect credit risk.

3. Obtain and review any other internal reports management uses to supervise agricultural lending activities. Examples include:

    - Loan trial balance, past dues, and non-accruals for agricultural portfolio.
    - Risk rating stratification report.
    - Copy of the most recent problem loan status report on adversely graded agricultural loans.
    - Loan review report with management's response.
    - Organizational chart of the agricultural lending department.
    - Resumes of agricultural lending department management and senior staff for any staff added since the last exam.

4. Discuss the following topics with management to determine the impact on the agricultural portfolio:

   - How management supervises the agricultural loan portfolio (individually, committee, division, etc.).
   - Concentrations within the agricultural loan portfolio (e.g., specific crops, type of livestock, orchards, agribusinesses, etc.).
   - Any significant changes in policies, procedures, personnel, and control systems affecting agricultural lending.
   - Any internal or external factors that could affect the agricultural loan portfolio.
   - Strategic plans, new initiatives, and other new initiatives.

5. Based on the performance of the previous steps, combined with discussions with the EIC and other appropriate supervisors, determine the examination scope and how much testing is necessary. Set examination objectives.

Quantity of Risk

Rating: The quantity of risk is (low, moderate, high).

Objective: Assess the types and levels of risk associated with individual agricultural loans and determine the appropriate classification.

1. Select a sample of loans to be reviewed. Sample should be adequate to assess compliance with policies, procedures, and regulations; verify the accuracy of internal risk ratings; and determine the quantity of credit risk. Refer to the *Comptroller's Handbook* for guidance on sampling techniques.

2. Prepare line sheets for sampled credits. Line sheets should contain sufficient information to determine the credit rating and support any criticisms of underwriting or credit administration practices. Refer to the *Comptroller's Handbook for National Bank Examiners* for guidance on completing line sheets.

3. To the extent established by the examination scope, pull loan files and perform the following testing steps:

   - Compare collateral held with the description on the collateral register.
   - Determine that the proper assignments, stock powers, hypothecation agreements, statements of purpose, etc., are on file.
   - Test the pricing of the negotiable collateral.
   - Determine that each file contains documentation supporting guarantees and subordination agreements, where appropriate.
   - List all collateral discrepancies and investigate.

4. Determine whether any previously charged-off agricultural loans have been re-booked. If so, determine whether the re-booked loans:

   - Comply with the bank's policy and terms for granting new loans.
   - Comply with OCC policy on re-booked charge-offs.
   - Should be classified.

5. Using a list of non-accruing loans, test loan accrual records to determine that interest income is not being recorded.

6. Assign proper classification to individual credits. See the "Loan Classification" discussion in the Introduction section of this booklet for key criteria to guide classification treatment.

Objective: Assess the types and levels of risk associated with the bank's agricultural lending activities and compliance with laws and regulations, including testing and verification, as deemed necessary.

1. Review any changes to the agricultural loan policy and determine their effect on the quantity of risk.

2. Review the current underwriting guidelines. Assess how changes since the previous examination may affect the quantity of risk.

3. Analyze the level, composition, and trend of policy and underwriting exceptions and determine the impact on the quantity of risk. (Note: A bank's lack of an internal tracking system indicates a need to test for adherence to policy.)

4. Analyze the composition and changes to the agricultural portfolio, including off-balance-sheet exposure, since the previous examination. Determine the implications for the quantity of risk of the following:

   - Any significant growth.
   - Material changes in the portfolio to include:
     – Changes and trends in problem, classified, past-due, nonaccrual, and non-performing assets; charge-off volumes; and risk- rating distribution.
     – Level of carry over debt.
   - Any significant concentrations, including geographic and product concentrations.
   - Agricultural loan portfolios acquired from other institutions.

5. Review and analyze management-prepared agricultural loan portfolio risk assessments. Determine whether management's risk assessments are supported by the examiners' analysis of the loan sample.

6. Review the business and/or strategic plan for the agricultural loan portfolio. Evaluate how implementation of the plan will affect the quantity of credit risk. Consider:

   - Growth goals and potential sources of new loans.
   - Growth outside the current market area.
   - New products and business lines.
   - Concentrations of credit.
   - Management's expertise, history, and experience with the plan's products and loans.

7. Review the local, regional, and national economic trends and assess their impact on agricultural portfolio risk levels. Consider whether

management has reasonably factored this data into projections of loan growth and quality.

8. Compare agricultural portfolio performance with planned performance and ascertain the risk implications.

9. If the bank employs concentration management tools (e.g., portfolio limits, loan sales, derivatives) to control credit exposures, analyze the impact on the quantity of risk. Consider:

   - The objectives of these programs.
   - Management’s experience and expertise with these tools.

10. Review recent loan reviews of agricultural credits and any related audit reports. If there are any adverse trends in quantitative measures of risk or control weaknesses reported, comment on whether and how much they may increase credit risk.

11. Analyze the level, composition, and trend of agricultural loan documentation exceptions and determine the potential risk implications.

12. Review inspection reports on agricultural loans to determine if on-site inspections are performed in accordance with bank policy.

13. Evaluate the adequacy of the allowance for loan and lease losses for the agricultural portfolio.

14. Evaluate the level of compliance with the laws, rules, and regulations contained in the “References” section of this booklet. Relate the level of compliance to the quantity of credit risk. Test for compliance as necessary.

15. Determine whether the consumer compliance examination uncovered any violations of law or regulation in the agricultural department.

16. If violations were noted, determine whether management took adequate corrective action.

Quality of Risk Management

Rating: The quality of risk management is (weak, acceptable, or strong).

Policy

Objective: Determine whether the board, consistent with its duties and responsibilities, has established adequate policies appropriate for the complexity and scope of the bank's agricultural lending activities.

1. Evaluate the adequacy of agricultural loan policies. Consider whether:

   - Policies address agricultural loan structuring.
   - Loan maturities reflect the purpose and source of repayment.
   - Requirements are specified for annual operating lines and capital purchase loans.
   - Carry-over debt is amortized.
   - How credit enhancements are used to support credit underwriting:
     – Farm Service Agency programs.
     – SBA programs.
     – State-level programs.
     – Personal guarantees.
   - Collateral margins are established for specific types of agricultural lending, such as:
     – Crops.
     – Livestock (cattle, poultry, hogs, exotic animals).
     – Machinery and equipment.
     – Real estate.
   - How agricultural exceptions are defined, identified, monitored, and controlled.
   - Whether the policy establishes concentration guidelines for the agricultural portfolio and whether the policy outlines actions to be taken when policy limits are exceeded.
   - Whether all credit risk exposures (off-balance-sheet activity, contingent liability, related personal debt, etc.) are captured and included in the borrower's relationship for credit risk management purposes.
   - Whether the policy establishes guidance for monitoring hedging strategies, forward contracting, third-party contracts, and timing of cash market sales.
   - Whether the policy addresses and identifies potential environmental concerns.

2. Does the board review and approve the agricultural loan policies annually?

- Does it evaluate existing policies to determine if they are compatible with market conditions?
- Does it ensure policies are consistent with the bank's strategic direction and risk tolerance?

Processes

Objective: Determine whether lending practices, procedures, and internal controls regarding agricultural loans are adequate.

1. Evaluate how polices, procedures and plans affecting the agricultural portfolio are communicated. Consider:

   - Whether management has clearly communicated objectives and risk limits for the agricultural portfolio to the board of directors and whether the board has approved these goals.
   - Whether communication to key personnel in the agricultural department is clear and timely.

2. Determine whether management information systems provide timely, useful information to evaluate risk levels and trends in the agricultural portfolio.

3. Assess the process to ensure the accuracy and integrity of agricultural loan data.

4. Determine the effectiveness of processes to monitor compliance with the agricultural policy. Consider:

   - Approval and monitoring of policy limit exceptions.
   - The volume and type of exceptions, including any identified in the loan sample.
   - Internal loan review, audit, and compliance process findings.

5. Assess the underwriting process for agricultural lending. Consider:

   - The appropriateness of the approval process.
   - The quality of credit analysis.

6. Evaluate the accuracy and integrity of the internal risk-rating processes. Consider:

   - Whether risk ratings appropriately consider any added support derived from the self-liquidating nature of certain types of agriculture collateral.
   - Findings from the loan sample.

- The role of loan review.

7. Determine whether there are processes to monitor strategic and business plans for the agricultural portfolio. Consider:

   - The impact on earnings and capital if agricultural portfolio business plans and strategies are executed.
   - Requirements for federal or state sponsored programs.

8. Assess the process to ensure compliance with applicable laws, rulings, regulations, and accounting guidelines.

   - Consider specialized lending programs sponsored by the Farm Service Agency or state agriculture departments.

9. Evaluate the effectiveness of processes used to monitor collateral. Consider:

   - For livestock, are inspections performed, at a minimum, annually?
     – Is there a breakdown by sex, breed, and number in each category?
     – Is the condition of the animal noted?
     – Are published livestock prices used to prepare cash flow projections?
   - For crop loans, are inspections of growing crops performed as the loans are advanced?
     – Does the bank monitor local/regional crop yields?
     – Are published commodity prices used for cash flow projections?
     – If published commodity prices are not used, does the bank document the support for their prices?
   - Does the bank have adequate processes to monitor farm land values and commodity prices?
   - Are periodic inspections conducted for capital assets, machinery, and equipment?
   - Does the bank have processes to verify the perfection of liens and the adequacy of insurance coverage?

10. The examiner reviewing the agricultural lending portfolio should review the LPM examiner's findings to determine whether additional analysis is required for issues related to agricultural lending pertaining to:

    - Problem credit administration.
    - Collections.
    - Charge offs.
    -

11. Review the methodology for evaluating and maintaining the Allowance for Loan and Lease Losses.

    - Consider whether the portfolio is analyzed as a separate pool or further segmented by loan type (crop loans, livestock loans, etc.) or geographic area.
    - Is the methodology reasonable based on historical experience and current trends?

12. Verify that the bank has an effective process to periodically evaluate internal controls. (**Note: The lack of an effective process may require examiners to conduct additional testing.**)

13. Evaluate the adequacy of internal controls within the agricultural lending department. Consider:

    - Segregation of duties:
    - Are delinquent account collection requests and past due notices checked to the trial balances that are used to reconcile agricultural loan subsidiary records with general ledger accounts, and are they handled only by persons who do not also handle cash?
    - Is the preparation and posting of interest records performed or reviewed by persons who do not also handle cash or issue official checks or drafts singly?
    - Are the functions of receiving and releasing collateral to borrowers and of making entries in the collateral register performed by different employees?
    - Are collection notices handled by someone not connected with loan processing?
    - Is negotiable collateral held under joint custody?

Personnel

Objective: Given the size and complexity of the bank, determine whether management/agricultural lending personnel possess and display acceptable knowledge and technical skills to manage and perform their duties.

1. Evaluate the adequacy of the agricultural lending staff in terms of level of expertise and number of assigned personnel. Consider:

    - Whether staffing levels will support current operations or any planned growth.
    - Staff turnover.
    - The staff’s previous agricultural lending and workout experience.
    - Specialized training provided.

- Assess the average account load per lending officer. Consider reasonableness in light of the complexity and condition of the officer's portfolio.
- Assess how senior management and the board of directors periodically evaluate agricultural lenders' understanding of and conformance with the bank's stated credit culture and loan policy. If there is no process, determine the impact on the management of credit risk.

2. Assess the performance management and compensation programs for agricultural lending personnel. Consider whether these programs measure and reward behaviors that support strategic and risk tolerance objectives for the portfolio.

Controls

Objective: Determine whether effective control systems are in place to monitor compliance with established agricultural lending policies and processes and to identify, measure, monitor, and control agricultural lending risk.

1. Evaluate the adequacy of management information systems (MIS) available for the agricultural portfolio. Consider whether:

   - Reports identify and provide sufficient data about the performance of loans with underwriting and policy exceptions.
   - Reports provide sufficient detail about portfolio segments and concentrations, including carryover debt.
   - Reports provide sufficient information to ensure collateral inspections are conducted in a timely manner.
   - Reports provide adequate information to comply with the reporting requirements for any federal and state agriculture programs.

2. Determine the effectiveness of the loan review system in identifying risk in the agricultural portfolio. Consider:

   - Scope, coverage, and frequency of reviews.
   - Comprehensiveness and accuracy of findings/recommendations.
   - Adequacy and timeliness of follow-up.

3. Determine the effectiveness of the audit and compliance review functions. Consider the following:

   - Scope, coverage, and frequency of reviews.
   - Comprehensiveness and accuracy of findings/recommendations.
   - Ongoing monitoring activities.

- Adequacy and timeliness of corrective actions if violations or deficiencies were identified.

4. Determine whether management has an effective internal control system for documentation exceptions and collateral monitoring.

5. Evaluate the effectiveness of control systems that monitor compliance with the requirements of government agricultural lending programs.

6. Determine the responsiveness of control systems to identified internal weaknesses in policy, process, personnel, or controls for agricultural lending.

Conclusions

Objective: Determine overall conclusions and communicate findings regarding the quantity of risk and management's ability to identify, measure, monitor, and control risk in agricultural lending.

1. Prepare a summary memorandum to the LPM examiner or EIC regarding the quantity and direction of credit risk, and the adequacy of the risk management for the agricultural loan portfolio. Consider:

   - Appropriateness of strategic and business plans for agricultural lending.
   - Adequacy of policies and underwriting standards.
   - Volume and severity of classified loans.
   - Volume and severity of underwriting and policy exceptions.
   - Concentrations of credit.
   - Accuracy and timeliness of agricultural MIS.
   - Compliance with applicable laws, rules, and regulations.
   - Adequacy of agricultural loan control functions.
   - Recommended corrective action regarding deficient policies, procedures, practices, or other concerns and commitments obtained from management.
   - The extent to which agricultural credit risk and credit risk management practices affect aggregate loan portfolio risk.

2. Recommend risk assessments for the agricultural portfolio for the following applicable risks. Refer to the "Community Bank Supervision" and "Large Bank Supervision" booklets for guidance.

   For Large Banks Only:

   - Quantity of Risk: High, Moderate, Low
   - Risk Management: Strong, Satisfactory, Weak

   For All Banks:

   - Risk Direction: Increasing, Stable, Decreasing
   - Aggregate Risk: High, Moderate, Low

3. Discuss examination findings and conclusions with the EIC. If necessary, compose "Matters Requiring Board Attention" (MRBA) for the report of examination (ROE).

   - MRBAs should cover practices that:
     – Deviate from sound, fundamental principles and are likely to result in financial deterioration if not addressed.

- Result in substantive noncompliance with laws.

MRBAs should discuss:

- Causative factors contributing to the problem.
- Consequences of inaction.
- Management's commitment for corrective action.
- The time frame and individual responsible for corrective action.

4. Based on discussions with the EIC, bank management, and information contained in the summary memorandum, prepare a brief agricultural lending comment for inclusion in the ROE.

5. Discuss findings with bank management, including conclusions about risks. If necessary, obtain commitments for corrective action.

6. Provide any necessary information to the LPM examiner to update the supervisory record and any applicable report of examination schedules or tables.

7. Prepare a memorandum with recommendations for future examinations.

8. Update the agricultural lending examination work papers in accordance with OCC guidance.

Federal Guaranty and Support Programs

The Department of Agriculture has a number of loan guaranty programs that are intended to assist small farmers and residents of rural communities. The programs described in this section were originally implemented by the Farmers Home Administration (FmHA), an agency within the Department of Agriculture. Although the FmHA was abolished in a reorganization, its programs remain intact and are administered by other units within the Department of Agriculture, such as the Farm Service Agency.

Farm Service Agency

Farm lending by the Farm Service Agency (FSA) is probably the most familiar of the government loan programs in rural areas. The FSA operates numerous offices and administers USDA's commodity income and price support programs, farm credit programs, and federal crop insurance programs. FSA provides farm loans to producers unable to obtain credit elsewhere at reasonable rates and terms. FSA loans serve as the federal government's primary credit safety net for agricultural producers. To qualify for loans, an applicant must demonstrate sufficient farm training or farm experience and be, or will become, an operator of a family-sized (or smaller) farm.

FSA provides credit assistance to farmers through two mechanisms: loan guarantees and direct loans. Direct loans are made and serviced directly by FSA staff, often at subsidized interest rates and concessionary terms and collateral requirements. FSA also guarantees certain types of loans made and serviced by qualified commercial or cooperative lenders.

Loan Guarantees. Under a guaranteed loan, FSA guarantees repayment of up to 90 percent of a loan made by a qualifying lender if the borrower defaults. A 95 percent guarantee is available for the refinancing of direct loan program indebtedness. FSA's guarantee is transferable and many guaranteed loans are sold through formal and informal secondary markets. However, the FSA makes a relatively small number of guaranteed loans, as commercial banks are the major source of guaranteed loans. Interest rates are negotiated between the lender and the borrower, but are not to exceed the average rate the lender offers to its farm customers. This requirement and the government assumption of risk provide borrowers with more favorable rates than otherwise might be obtainable. FSA can provide interest rate subsidies of up to 4 percentage points on guaranteed loans.

Direct Loans. FSA offers three groups of loan programs: farm ownership (FO), operating loans (OL), and emergency disaster (EM) loans.

Farm Ownership (FO). FO direct and guaranteed loans are available for the purchase or improvement of farm real estate. Guaranteed loans also are available to help owner-operators restructure their debts using real estate equities. Loans are capped at $200M for a direct loan and $300M for a guaranteed loan.

Operating Loans (OL). OL loans are available for a variety of purposes, including the purchase of livestock and farm equipment, annual operating expenses, the refinancing of existing indebtedness and essential family living expenses. The loan limit is $200M for a direct loan and $400M for a guaranteed loan.

Emergency Loans (EM). EM loans are made directly by FSA. EM loans are available to producers in designated areas where property damage or severe production losses have occurred due to a natural disaster, such as a flood or drought. Loans are made for the actual losses arising from the natural disaster for amounts up to a maximum of $500M per applicant. EM loans may be made to repair, restore, or replace damaged farm property and to compensate for loss of income based on reduced production of crops or livestock resulting from the disaster. For EM loan requests over $100M, the applicant must provide the FSA with written confirmation from two commercial lenders that the requested credit could not be obtained.

Effects of 1996 Farm Bill on FSA. The Federal Agricultural Improvement and Reform Act of 1996 (Farm Bill) made extensive changes to FSA's farm credit programs, especially to its direct credit programs. The Farm Bill encourages "graduation" from FSA credit programs (that is, shifting from FSA credit programs to commercial credit sources) by placing stricter limits on the eligibility to borrow through FSA programs.

Credit Program Changes and Restrictions

New FO loans can only be made to qualified beginning farmers or to those with less than 10 years of FSA borrowing experience. Direct FO loans used to refinance existing indebtedness are now prohibited. To facilitate graduation to commercial sources, FSA was authorized to make 95 percent guarantees of commercial loans used to refinance direct FO loans.

Direct OL loans can still be used to refinance existing indebtedness. But this is limited to applicants who have refinanced a direct or guaranteed loan fewer than five times before and who are existing, direct OL program borrowers that have suffered a qualifying loss because of a natural disaster, or are refinancing loans obtained outside FSA. FO or OL loans to finance nonfarm business purposes are no longer authorized.

OL program eligibility is also more restrictive. These loans can only be made to farmers who have not operated a farm or ranch for more than five years or to applicants with no more than six years of OL borrowing experience. Transitional eligibility rules for existing FSA borrowers apply to both loan programs.

Changes were made to the Emergency Loan (EM) program to reduce program costs. Stricter eligibility requirements are now applied, asset valuation procedures have been revised, and the $500M cap on the program now applies to the total program indebtedness of the borrower, instead of being applied only to a particular disaster.

Other Changes

Numerous changes under the Farm Bill assist beginning farmers — those with less than 10 years experience operating a farm or ranch. FSA can now guarantee up to 95 percent of operating loans made to beginning farmers participating in its down payment loan program, up from 90 percent. And FSA may now provide direct farm ownership loans at as little as 4 percent interest under joint financing arrangements, where another lender provides 50 percent or more of the amount financed.

New loan servicing and debt restructuring rules are designed to increase the likelihood that debt restructuring will be successful in helping farmers stay in business, and to reduce the government's cost associated with these actions. Most noteworthy among the change are rules that strictly limit a borrower to just one instance of debt forgiveness and make these borrowers ineligible for additional direct or guaranteed loans. Also borrowers with delinquent loan accounts are no longer eligible for new direct operating loans.

Commodity Credit Corporation

The Commodity Credit Corporation (CCC) is a government-owned and operated corporation created in 1933 to help stabilize and support farm prices and income, and to help maintain balanced supplies and the orderly distribution of agricultural commodities. The CCC's operations for the Department of Agriculture include commodity price support and inventory management programs, donations, and sales of government-owned stocks for humanitarian or commercial uses, and foreign market development and export credit guarantee programs.

Among the many programs administered by the CCC, the Export Credit Guarantee programs and the Commodity Price Support Loan and Purchase Program should be of most interest to banks and examiners.

Export Credit Guarantee Programs. The export guarantee programs are intended to encourage U.S. financial institutions to provide financing where they would be unwilling to extend credit in the absence of the CCC guarantee. Under the Export Credit Guarantee Program (GSM-102), which was instituted in 1980, the CCC guarantees, for a fee, payments due U.S. exporters under deferred payment sales contracts of up to 36 months. The guarantee provides protection against defaults due to commercial as well as noncommercial risks. The Intermediate Export Credit Guarantee Program (GSM-103) was implemented in 1986. The program is similar to the GSM- 102 program, but provides the CCC guarantee to exporters for commodities sold on credit terms in excess of three years, but not more than 10 years. Documentation requirements for both the GSM-102 and GSM-103 programs are very specific and require strict adherence to perfect the CCC guarantee.

Commodity Price Support Loan and Purchase Program. Governmental price support is undergoing significant change. The Farm Bill includes material changes regarding crop subsidies. Among other things, the Farm Bill phases out crop subsidies over the next seven years. Eligible farmers will get fixed, sliding-scale payments through 2002. The effect of these changes will eliminate price protection for several crops and pose greater risk from market prices to farmers.

Price support is achieved through CCC loans, target price deficiency payments, and purchases of selected commodities at announced levels. The price support loan program gives producers an opportunity to obtain operating cash and remove their crops from the market for potential later sale. Producers are guaranteed at least the support price for the commodity they have pledged as collateral for the loan.

CCC price support loans are nonrecourse loans. If market prices are above support levels, producers may market their commodity and pay off their loans with interest. If market prices fail to rise above support levels, producers can deliver the commodity to the CCC and discharge their obligation. When the producer also has operating loans from another lender, the lender would be required to sign a lien waiver in favor of the CCC.

Most farm program payments to producers may be assigned to a lender. However, price support loans, purchase agreement proceeds, and payments made in the form of Commodity Certificates are not assignable.

Lending Limits

Agricultural lending activities occasionally require the application of special lending limits. The special lending limits are as follows:

12 CFR 32.3 Lending limits.

(a) *Combined general limit*. A national bank's total outstanding loans and extensions of credit to one borrower may not exceed 15 percent of the bank's capital and surplus, plus an additional 10 percent of the bank's capital and surplus, if the amount that exceeds the bank's 15 percent general limit is fully secured by readily marketable collateral, as defined in 12 CFR 32.2(m). To qualify for the additional 10 percent limit, the bank must perfect a security interest in the collateral under applicable law and the collateral must have a current market value at all times of at least 100 percent of the amount of the loan or extension of credit that exceeds the bank's 15 percent general limit.

(b) ***Loans subject to special lending limits***. The following loans or extensions of credit are subject to the lending limits set forth below. When loans and extensions of credit qualify for more than one special lending limit, the special limits are cumulative.

(1) Loans secured by bills of lading or warehouse receipts covering readily marketable staples.

(I) A national bank's loans or extensions of credit to one borrower secured by bills of lading, warehouse receipts, or similar documents transferring or securing title to readily marketable staples, as defined in 12 CFR 32.2(n), may not exceed 35 percent of the bank's capital and surplus in addition to the amount allowed under the bank's combined general limit. The market value of the staples securing the loan must at all times equal at least 115 percent of the amount of the outstanding loan that exceeds the bank's combined general limit.

(ii) Staples that qualify for this special limit must be nonperishable, may be refrigerated or frozen, and must be fully covered by insurance if such insurance is customary. Whether a staple is non-perishable must be determined on a case-by-case basis because of differences in handling and storing commodities.

(iii) This special limit applies to a loan or extension of credit arising from a single transaction or secured by the same staples, provided that the duration of the loan or extension of credit is:

(A) Not more than ten months if secured by nonperishable staples; or

(B) Not more than six months if secured by refrigerated or frozen staples.

(iv) The holder of the warehouse receipts, order bills of lading, documents qualifying as documents of title under the Uniform Commercial Code, or other similar documents, must have control and be able to obtain immediate possession of the staple so that the bank is able to sell the underlying staples and promptly transfer title and possession to a purchaser if default should occur on a loan secured by such documents. The existence of a brief notice period, or similar procedural requirements under applicable law, for the disposal of the collateral will not affect the eligibility of the instruments for this special limit.

(A) Field warehouse receipts are an acceptable form of collateral when issued by a duly bonded and licensed grain elevator or warehouse having exclusive possession and control of the staples even though the grain elevator or warehouse is maintained on the premises of the owner of the staples.

(B) Warehouse receipts issued by the borrower-owner that is a grain elevator or warehouse company, duly-bonded and licensed and regularly inspected by state or federal authorities, may be considered eligible collateral under this provision only when the receipts are registered with an independent registrar whose consent is required before the staples may be withdrawn from the warehouse.

(2) Exception removed. (Not related to agriculture.)

(3) Loans secured by documents covering livestock.

(I) A national bank's loans or extensions of credit to one borrower secured by shipping documents or instruments that transfer or secure title to or give a first lien on livestock may not exceed 10 percent of the bank's capital and surplus in addition to the amount allowed under the bank's combined general limit. The market value of the livestock securing the loan must at all times equal at least 115 percent of the amount of the outstanding loan that exceeds the bank's combined general limit. For purposes of this subsection, the term "livestock" includes dairy and beef cattle, hogs, sheep, goats, horses, mules, poultry and fish, whether or not held for resale.

(ii) The bank must maintain in its files an inspection and valuation for the livestock pledged that is reasonably current, taking into account the nature and frequency of turnover of the livestock to which the documents relate, but in any case not more than 12 months old.

(iii) Under the laws of certain states, persons furnishing pasturage under a grazing contract may have a lien on the livestock for the amount due for pasturage. If a lien that is based on pasturage furnished by the lienor prior to the bank's loan or extension of credit is assigned to the bank by a recordable instrument and protected against being defeated by some other lien or claim, by payment to a person other than the bank, or otherwise, it will qualify under this exception provided the amount of the perfected lien is at least equal to the amount of the loan and the value of the livestock is at no time less than 115 percent of the portion of the loan or extension of credit that exceeds the bank's combined general limit. When the amount due under the grazing contract is dependent upon future performance, the resulting lien does not meet the requirements of the exception.

(4) Loans secured by dairy cattle. A national bank's loans and extensions of credit to one borrower that arise from the discount by dealers in dairy cattle of paper given in payment for the cattle may not exceed 10 percent of the bank's capital and surplus in addition to the amount allowed under the bank's combined general limit. To qualify, the paper:

(I) Must carry the full recourse endorsement or unconditional guarantee of the seller; and

(ii) Must be secured by the cattle being sold, pursuant to liens that allow the bank to maintain a perfected security interest in the cattle under applicable law.

Agister's Lien—A statutory lien granted in most states to help assure a feedlot will be paid for feed and yardage services rendered. A perfected agister's lien grants the feedlot a first security interest in a customer's cattle and takes preference over a purchase money security interest.

Agronomy—Study of the management of land resources and scientific crop cultivation.

ASCS—Agricultural Stabilization and Conservation Services. Government agency administering enrollment and compliance with government programs.

Backgrounding—Allowing lighter feeder cattle to graze on wheat or grass for weight gain prior to initiating the finishing process in feed yards.

Barrow—Castrated male pigs raised for slaughter.

Boars—Male pigs used for breeding purposes. Their weight can reach 800 lbs.

Bu—Abbreviation for bushel. Bull. Male cattle, usually of breeding age. Calf. Young male or female cattle.

Carryover—Any amount of short-term operating debt left unpaid due to inability of borrower's operation to generate sufficient income. This amount is "carried over" and restructured into longer term debt.

Cash Grain—Harvested crops to be sold in the market.

Commodity Credit Corporation (CCC)—Conservation Reserve Program (CRP). Program established to prevent the

Conservation Reserve Program (CRP)—Program established to prevent the erosion of highly erodible farmland and limit crop production. Land enrolled in the program generally cannot be tilled for the duration of the contract.

Conversion Rate—The number of pounds of weight gained from number of pounds of feed consumed. Information is used to determine feed yard efficiency, adverse impact of weather, and suitability of livestock to a geographic region.

Cow/Calf Operation—Borrower owns breeding livestock with income derived from the successful reproduction and sale of offspring.

Cover Crop—Crop planted to improve soil and/or prevent erosion.

Crop Share Lease—Land leased by a farmer in exchange for a percentage share in the crop production.

Cull—Animals no longer desired for production or breeding purposes and are sold in the market.

Custom Work—. Machine work, particularly crop harvesting, done for others on an hourly or acreage basis.

Cwt—Abbreviation for hundred weight, a common measure for agricultural products. For example hogs, cows, and milk are priced by the hundred weight or cwt.

Dairy Cow—A female that has already had a calf; therefore, capable of milk production.

DHIA—Dairy Herd Improvement Association. Cooperatives that provide financial and other management information to its member farmers.

Deficiency Payment—Terminology normally associated with proceeds paid to a farmer from government subsidy programs.

Duroc—A common breed of hogs. Other common breeds are Chesterwhites, Hampshire, York, and Poland China.

Ewe—A mature female sheep.

Farm Credit Service—Government sponsored lending enterprise Formerly known as Federal Land Bank (FLB) and Production Credit Association (PCA).

Laws

Lending Limits	12 USC 84
Protection for Purchasers of Farm Products	7 USC 1631

Regulations and Rulings

Lending limits	12 CFR 32
Loans in areas having special flood hazards	12 CFR 22
Loans relating to Commodity Credit Corporation programs	7 CFR 1400-1499
Real estate appraisals	12 CFR 34, Subpart C

Other References

Banking Laws for Examiners, OCC

Banking Regulations for Examiners, Volumes 1 - 4, OCC

BC 248, Sale of Loans into the Federal Agricultural Mortgage Corporation Program